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SEC Provides No-Action Relief to M&A Brokers in Connection With Broker-Dealer Registration Requirements

On January 31, 2014, the Division of Trading and Markets (the “Division”) of the Securities and Exchange Commission (the “SEC”) issued a no-action letter (as revised on February 4, 2014, the “No-Action Letter”)¹ that permits an M&A Broker (as defined below) to engage in certain activities in connection with the purchase or sale of privately-held companies without registering as a broker-dealer under Section 15(b) of the Securities Exchange Act of 1934 (the “Exchange Act”).

Background

Prior to the No-Action Letter, although a person who had not registered as a broker-dealer could engage in activities in connection with the sale of a business structured as an asset sale, unregistered persons generally were not permitted to effect the sale of a business structured as a securities sale. As a result, unregistered persons generally were not permitted to engage in activities such as negotiating on behalf of buyers and sellers, participating in the sale of a privately-held company or providing advice relating to the issuance or value of securities in connection with the sale of such a company. Although subject to many conditions and limitations, the No-Action Letter has significantly expanded the limited relief that the SEC previously had given in connection with such sales.

Covered Businesses and Brokers

The relief provided by the No-Action Letter is limited to securities transactions effected by an M&A Broker in connection with the transfer of ownership of a “privately-held company,” which is defined in the No-Action Letter as a company that does not have any class of securities registered, or required to be registered, with the SEC under Section 12 of the Exchange Act, or with respect to which the company files, or is required to file, periodic information, documents or reports under Section 15(d) of the Exchange Act. Any privately-held company accorded this relief must be an operating company that is a going concern and not a “shell” company.²

An “M&A Broker” is defined in the No-Action Letter as a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company.

1 Copies of the No-Action Letter and the request letter to which it responded are available at: <https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf>.

2 The No-Action Letter defines a “shell” company as a company that (1) has no or nominal operations and (2) has: (i) no or nominal assets, (ii) assets consisting solely of cash and cash equivalents or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets. In this context, a “going concern” need not be profitable, and could even be emerging from bankruptcy, so long as it actually has been conducting business, including soliciting or effecting business transactions or engaging in research and development activities.

Covered Activities

The No-Action Letter provides relief permitting M&A Brokers to:

- facilitate mergers, acquisitions, business sales, and business combinations (together, “M&A Transactions”) between sellers and buyers of privately-held companies, without regard to the size of the privately-held companies;³
- advertise a privately-held company for sale with information such as the description of the business, general location and price range;
- participate in the negotiations of M&A Transactions;
- advise the parties to issue securities, or otherwise to effect the transfer of the business by means of securities;
- assess the value of any securities sold; and
- receive transaction-based or other compensation, as agreed by the parties.

Conditions to the SEC Relief

The relief provided by the No-Action Letter was based on the facts and representations included in the letter requesting relief. Based on the representations highlighted by the SEC in providing such relief, M&A Brokers will need to satisfy the following conditions:

- ***Inability to Bind Parties:*** M&A Brokers may not have the ability to bind a party to an M&A Transaction.
- ***Prohibition on Financing:*** M&A Brokers may not, directly or indirectly through affiliates, provide financing for an M&A Transaction, although they may assist purchasers to obtain financing from unaffiliated third parties if they comply with all applicable requirements and disclose any related compensation in writing to the client.
- ***No Custody of Funds or Securities:*** M&A Brokers may not have custody, control or possession of, or otherwise handle funds or securities issued or exchanged in connection with, an M&A Transaction or other securities transaction for the account of others.
- ***No Public Offerings:*** The relevant M&A Transactions may not involve public offerings of securities. Any offering or sale of securities must be conducted in compliance with an applicable exemption from registration under the Securities Act of 1933 (the “Securities Act”).
- ***No Shell Companies:*** No party to an M&A Transaction may be a shell company, other than a business combination related shell company.⁴
- ***Dual Representation of Buyers and Sellers:*** If an M&A Broker represents both buyers and sellers, it must provide clear written disclosure as to the parties it represents and obtain written consent from both parties to the joint representation.

³ In contrast, the prior relief and the legislation referenced in footnote 7 below contained limits on the size of the privately-held companies to which the relief or exemption from broker-dealer registration applied.

⁴ The No-Action Letter defines a “business combination related shell company” as a shell company (as defined in Rule 405 of the Securities Act) that is (1) formed by an entity that is not a shell company solely for the purpose of changing the corporate domicile of that entity solely within the United States; or (2) formed by an entity that is not a shell company solely for the purpose of completing a business combination transaction (as defined in Securities Act Rule 165(f)) among one or more entities other than the shell company, none of which is a shell company.

- **Groups of Buyers:** An M&A Broker may only facilitate an M&A Transaction with a group of buyers if the group is formed without the assistance of the M&A Broker.
- **Control by the Buyer(s):** Upon completion of any M&A Transaction, the buyer or group of buyers must control and actively operate the company or the business conducted with the assets of the business. According to the No-Action Letter, the buyer (or a group of buyers collectively) would have the necessary control if it has the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract or otherwise, and such necessary control shall be presumed to exist if, upon completion of the M&A Transaction, the buyer or group of buyers has: (1) the right to vote 25% or more of a class of voting securities; (2) the power to sell or direct the sale of 25% or more of a class of voting securities; or (3) in the case of a partnership or limited liability company, the right to receive upon dissolution, or has contributed, 25% or more of the capital.
- **Active Operations:** The buyer (or group) must actively operate the company or the business conducted with the assets of the company and not act as passive owners. A buyer could actively operate the company through the power to elect executive officers and approve the annual budget or by service as an executive or other executive manager, among other things.
- **Restricted Securities:** Any securities received by a buyer or the M&A Broker in an M&A Transaction must be restricted securities within the meaning of Rule 144(a)(3) under the Securities Act.
- **Barred Brokers:** An M&A Broker (and, if the M&A Broker is an entity, each officer, director or employee of the M&A Broker) may not (1) have been barred from association with a broker-dealer by the SEC, any state or any self-regulatory organization and (2) be suspended from association with a broker-dealer.

Conclusion

The No-Action Letter provides a long-awaited expansion of the prior relief relating to M&A Brokers following discussions and proposals going back many years.⁵ There may be further developments on the subject of broker-dealer requirements. It is notable that the No-Action Letter does not directly address the scenario highlighted last year by David Blass, Chief Counsel of the Division, concerning potential broker-dealer registration issues where private fund advisers or their affiliates or personnel receive transaction-based compensation relating to fund portfolio companies.⁶ Furthermore, Congress recently has been considering bills relating to M&A Brokers,⁷ although it is currently unclear if, or in what form, any such legislation may be adopted. The relief afforded by the No-Action Letter is limited to the registration requirements of Section 15(a) of the Exchange Act and does not extend to the applicability of any other federal or state laws relating to broker-dealer or other requirements.

5 See Am. Bar Assoc., *Report and Recommendations of the Task Force on Private Placement Brokers* (2005), available at: <http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf>.

6 Please refer to our client mailing "SEC Staff Warns That Advisers May Be Required to Register as Broker-Dealers" (Apr. 22, 2013), available at: <http://www.skadden.com/insights/sec-staff-warns-advisers-may-be-required-register-broker-dealers>.

7 See S. 1923, 113th Cong. (2014), and H.R. 2274, 113th Cong. (2014), which was passed by the House of Representatives on January 14, 2014, and is currently pending in the Senate.